

INTERNAL REVENUE SERVICE

Number: **INFO 2000-0275**

Release Date: 12/29/2000

Index Number 1402.01-00

September 29, 2000

The Honorable Sue Kelly
U.S. House of Representatives
Washington, D.C. 20515

Attention: Al Garesche

Dear Ms. Kelly:

This letter is in response to your inquiry dated August 17, 2000, forwarding correspondence of your constituent, [REDACTED], regarding his view that the Self-Employment Contributions Act (SECA) tax is inequitable for retirees and deters individuals from continuing to work after age 65. [REDACTED] is concerned that the method of calculating the SECA tax reduces his Social Security benefits and gives him a greater SECA tax liability than would seem fair.

The SECA tax is structured with the intent of putting a self-employed taxpayer in a similar position to an employee for employment taxes. An employee must pay half of the applicable employment taxes, and the employer pays the other half. Both portions of the employment tax are calculated as the product of the applicable tax rate and the employee's wages before applying employment taxes. Similarly, the SECA tax is calculated initially as the product of the applicable tax rate and the self-employed taxpayer's net earnings from self employment before applying the SECA tax. However, because an employee is not taxed on the employer's portion of the employment taxes, SECA allows for the deduction of one half of that initially calculated SECA tax (corresponding to the employer's half of employment taxes) in calculating the self-employed taxpayer's net earnings from self-employment. In addition, SECA allows for a deduction of one half of the final calculated SECA tax (again corresponding to the employer's half of employment taxes) in determining the self-employed taxpayer's income tax.

SECA TAX

Self-employed taxpayers are subject to SECA tax. SECA tax consists of the old-age, survivors and disability insurance (OASDI) taxes imposed under section 1401(a) of the Internal Revenue Code (the Code) and the hospital insurance (medicare) taxes imposed under section 1401(b). In determining the self-employment tax, the maximum self-employment income subject to the OASDI tax rate is equal to the Social Security

wage base (\$72,600 for the 1999 tax year). Self-employment income subject to the medicare tax rate is not limited.

In general, SECA tax is computed as a percentage of self-employment income, which is defined in section 1402(b) of the Code as the net earnings from self-employment derived by an individual, with certain adjustments. Section 1402(a) defines “net earnings from self-employment” as the gross income derived by an individual from any trade or business carried on by such individual, less certain allowed deductions, which can be attributed to such trade or business, plus his distributive share (whether or not distributed) of partnership income or loss from any trade or business carried on by a partnership of which he is a member, subject to certain exceptions. SECA taxes currently equal 15.3% of net earnings from self-employment, which is the same rate that employers (7.65%) and employees (7.65%) combined pay in Federal Insurance Contribution Act (FICA) taxes.

THE SOCIAL SECURITY AMENDMENTS ACT OF 1983

Before the Social Security Amendments Act of 1983 (the Act), which was an effort to assure the solvency of the Social Security Trust Funds, the rate of SECA taxes was less than the combined employer-employee rate of FICA taxes. In general, self-employed taxpayers paid OASDI rates of approximately 75% and medicare rates of 50% of the combined employer-employee rates under FICA. The Act amended the Code and the Social Security Act to eliminate this disparity and to make the rates under SECA equal the combined employer-employee rates under FICA. The reason for this change is included in legislative history to the Act, which states “...the present tax treatment of self-employed individuals accounts for a major portion of the financial difficulties of the social security system. Removal of the subsidy to self-employed individuals will alleviate these difficulties.” H.R. Rep. No. 98-25, 98th Cong., 1st Sess. 32 (1983).

COORDINATED DEDUCTIONS UNDER SECTIONS 164(f) AND 1402(a)(12)

The Congress also enacted coordinated deductions under sections 164(f) and 1402(a)(12) of the Code, which are “... designed to achieve parity between employees and the self-employed.” H.R. Conf. Rep. No. 98-47, 98th Cong. 1st Sess. 126 (1983). The Conference Report explains how parity is achieved as follows:

1. The base of the self-employment tax is adjusted downward [under section 1402(a)(12)] to reflect the fact that employees do not pay *FICA tax* on the value of the employer’s FICA tax.

2. A deduction is allowed for income tax purposes [under section 164(f)], for half of SECA liability, to allow for the fact that employees do not pay *income tax* on the value of the employer's FICA tax.

Section 164(f)(1) of the Code allows a deduction from gross income of one-half of the self-employment taxes imposed by section 1401 for each such taxable year. Under section 164(f)(2) the deduction is attributable to a trade or business carried on by the taxpayer which does not consist of the performance of services as an employee.

In computing net earnings from self-employment, an individual may take a deduction equal to a taxpayer's net earnings multiplied by one-half of the sum of the old-age, survivors, and disability insurance tax rate and the medicare rate. Section 1402(a)(12) of the Code. That deduction is in lieu of the trade or business deduction under section 164(f) that would otherwise have been allowed in computing net earnings under the first sentence of section 1402(a). To simplify the calculation of this deduction, net earnings from self-employment after the deduction are calculated by multiplying the net earnings from self-employment before the deduction by 92.35% (100% less 7.65%, or half the 15.3% combined self-employment tax rate).

Section 1402(a)(12) does not cancel the income tax deduction under section 164(f) and does not provide an alternative deduction. Therefore, sections 164(f) and 1402(a)(12) of the Code are separate deductions available only to taxpayers who are subject to self-employment taxes. The deduction under section 164(f) is taken above the line and is available for income tax purposes only. The deduction under section 1402(a)(12) is available only for determining net earnings from self-employment.

EXAMPLE

To illustrate the calculation of the self-employment taxes, assume a taxpayer has net earnings from self-employment equal to \$90,000, before applying the deduction.

Self-employment net earnings	\$90,000
Less deduction (\$90,000 x 7.65%)	- <u>\$ 6,885</u>
Balance	\$83,115
Maximum subject to OASDI tax rate (1999)	\$72,600
OASDI tax (12.4% x \$72,600)	\$ 9,002
Amount to subject to HI tax rate	\$83,115
HI tax (2.9% x \$83,115)	\$ 2,410
Total self-employment tax (\$9,002 + \$2,410)	\$11,412

I hope the information is helpful to you in responding to [REDACTED]. If you need

additional information, please contact me or Stephen Tackney at (202) 622-6040.

Sincerely,

Will E. McLeod
Acting Chief, Employment Tax Branch 1
Office of Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)